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October 31, 2006

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Re: Tax Technical Corrections Act (H.R.6264 and S.4026)

Dear Gentlemen:

Enclosed are comments on the proposals included in H.R. 6264 and S.4026 related to the application of Code section 470 to partnerships and proposed clarification of the term "separate affiliated group" in section 355(b)(3). These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Susan P. Serota
Chair, Section of Taxation

Enclosure

cc: Hon. Henry M. Paulson, Jr., Secretary of the Treasury
Eric Solomon, Acting Deputy Assistant Secretary of the Treasury (Tax Policy)
Thomas Barthold, Acting Chief of Staff, Joint Committee on Taxation
Kolan Davis, Staff Director, Senate Finance Committee
Russell Sullivan, Democratic Staff Director, Senate Finance Committee
Robert Winters, Republican Chief Tax Counsel, House Ways and Means Committee
John Buckley, Democratic Chief Tax Counsel, House Ways and Means Committee

ABA SECTION OF TAXATION

COMMENTS ON

H.R. 6264 AND S.4026: THE TAX TECHNICAL CORRECTIONS ACT OF 2006

These comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association

Principal responsibility for preparing the comments on section 470 was exercised by James Sowell and Carol Kulish. The comments were reviewed by James Wreggelsworth, Chair of the Partnerships and LLCs Committee, Eric Sloan, Vice-Chair (Law Development) of the Partnerships and LLCs Committee, and James Lowy, Chair of the Real Estate Committee. The comments were further reviewed by Barbara S. de Marigny, Council Director for the Partnerships and LLCs Committee and the Real Estate Committee.

Principal responsibility for preparing the comments on section 355 was exercised by Lisa Zarlen, Steve Flanagan, and Karen Gilbreath Sowell, Chair of the Corporate Tax Committee. The comments were reviewed by Audrey Nacamuli and Glenn Carrington, Council Director for the Corporate Tax Committee.

Although many of the members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal income tax rules applicable to the subject matter addressed by these comments, or have advised clients on the application of such rules, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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EXECUTIVE SUMMARY

I. Comments on Proposed Technical Corrections to Code Section 470

The Tax Technical Corrections Act of 2006 ("Technical Corrections Act") would amend section 470¹ to provide rules regarding the application of section 470 to partnerships. As is explained below, we commend the drafters of the Technical Corrections Act for excluding some legitimate partnerships that are not engaged in the abuses that Congress intended to prevent from the application of section 470. We also commend the drafters for recognizing the need to exclude non-depreciable partnership property. Importantly, however, we believe that the legislation does not go far enough in excluding legitimate arrangements that have nothing to do with SILO transactions from being subject to the loss deferral regime. We also believe that the approach taken by the legislation will engender substantial uncertainty regarding whether and to what extent common business arrangements are subject to section 470, in contravention of sound tax policy. As is explained in more detail below:

- We believe that the legislation's retroactive expansion of the portion of a pass-thru entity's property that can be subject to the loss deferral rules is inappropriate and inconsistent with sound tax policy.
- The legislation provides an exception for partnerships that meet certain objective requirements (relating to funds not being set aside or subject to certain arrangements and to the lack of certain types of options). Because the economic arrangements that exist with respect to partnerships are so diverse, we believe that focusing on the economic relationship of the partners, partnership, and lenders in the manner specified will apply the loss deferral rules to far more partnerships than can be justified on policy grounds. Accordingly, we believe that, if this approach is pursued, an additional exception should be provided for property that is not subject to "use" or "control" by a tax-exempt partner and that "qualified allocations" should be determined by reference to section 514(c)(9)(E), rather than section 168(h)(6)(B). We also believe that consideration should be given to a more general anti-abuse rule for the application of section 470 to partnerships and to providing an exception when all taxable partners satisfy a threshold projected variance in their investment return with respect to the partnership. We also have highlighted significant problems with, and made suggestions regarding, the arrangement, set aside, and options rules.
- Numerous practical and technical issues exist that are fundamental to whether and how section 470 applies with regard to tiered partnerships. Given the large number of tiered arrangements, we believe it is inappropriate to leave resolution of these issues to regulations.
- We believe that the broad regulatory authority to expand the scope of section 470 with respect to partnerships should be narrowed significantly so as to potentially capture only those situations where the arrangement truly resembles a SILO.

¹ Except to the extent specified otherwise, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury regulations promulgated thereunder.

- We believe that certain additional exceptions and definitions need to be provided.
- Given the inability of taxpayers to have predicted the details of the technical correction, we believe that consideration should be given to applying section 470 only to partnership property acquired after the date the Technical Corrections Act was introduced (in non-leasing situations) and to providing appropriate transition relief for arrangements entered into before the Technical Corrections Act was introduced that may be difficult or impossible to modify.

If appropriate legislation cannot be enacted expeditiously, we strongly believe that the existing moratoria should be extended to taxable years beginning before January 1, 2007.

II. Comments on Proposed Technical Corrections to Code Section 355

The Tax Increase Prevention and Reconciliation Act of 2005 amended the active trade or business requirement of section 355(b) by adding paragraph (3), providing that all members of a corporation's "separate affiliated group" ("SAG") are treated as one corporation for purposes of the active trade or business requirement. In the Technical Corrections Act, Congress has proposed to clarify that the term SAG would not include any corporation that became an otherwise qualifying member of the SAG within the five-year period ending on the date of the distribution by reason of one or more transactions in which gain or loss was recognized in whole or in part.

This proposed change would undermine the so-called "expansion" doctrine embodied in Treasury Regulation § 1.355-3(b)(3)(ii) that permits a corporation to acquire a business in a taxable acquisition during the five-year period, provided that the business is an expansion of a pre-existing active business. The expansion doctrine is regularly relied upon by taxpayers to satisfy the active business requirement of section 355.

We recommend that the proposed technical correction not be enacted without modification to make clear that any such change will not interfere with the law that has developed to allow an expansion of a historic business. This could be accomplished by making clear that the expansion doctrine will be applied on an affiliated group basis, without regard to the SAG membership and providing examples to illustrate the principle.

ABA SECTION OF TAXATION

COMMENTS ON

H.R. 6264 AND S.4026: THE TAX TECHNICAL CORRECTIONS ACT OF 2006

I. Comments on Proposed Technical Corrections to Code Section 470

A. Introduction

Section 6 of the Technical Corrections Act would amend the “anti-SILO” rules of section 470 of the Internal Revenue Code to provide rules regarding the application of section 470 to partnerships. The amendment would expand the portion of a partnership’s losses and deductions that could be deferred, but would provide new exceptions for (1) non-depreciable property and (2) certain property that meets two specific requirements that are based on certain leasing rules contained in section 470(d). The amendment also would provide the Treasury Department (“Treasury”) and the Internal Revenue Service (“IRS”) with extremely broad regulatory authority based on certain vague concepts to subject partnerships to section 470, even if those entities would otherwise be excepted from the application of section 470. The amendment would apply retroactively to property acquired after March 12, 2004.

The application of section 470 to pass-thru entities is a critical issue to thousands of taxpayers in a variety of industries, as well as to those practitioners who advise pass-thru entities and their owners regarding compliance with the tax laws. We commend the drafters of the Technical Corrections Act for their efforts in attempting to limit the application of section 470 in the context of partnerships that are not engaged in “SILO” transactions and for recognizing the need to exclude non-depreciable partnership property. As is explained in more detail below, however, we have significant concerns regarding both the general direction and the particular details of the amendment contained in the Technical Corrections Act.

Very generally, we are concerned that, notwithstanding the provisions of the Technical Corrections Act, many partnerships will be subject to section 470 even though they are not engaged in, or being used to replicate, the kinds of transactions that Congress intended to subject to section 470. We also are concerned that the amendment will engender considerable uncertainty regarding how, whether, and to what extent section 470 applies to many common business arrangements. We also have concerns with respect to other compliance and policy issues, including effective date concerns.

Before elaborating upon our concerns regarding the amendment, we believe it is useful to provide some brief background regarding current law and the comments we previously submitted regarding the application of section 470 to pass-thru entities.

B. Background Regarding Current Law

Section 470 is a loss deferral provision that was enacted as part of the American Jobs Creation Act of 2004 (P.L. 108-357, the “2004 Act”). Section 470 was primarily designed to address concerns with certain SILO (*i.e.*, sale-in, lease-out) transactions the Government considers abusive. These transactions typically involved a sale of property (such as a subway system) by a tax-exempt entity (such as a municipal transit authority)

to a taxable entity that, in turn, leased the property back to the tax-exempt entity. The taxable entity benefited from the cost recovery deductions associated with the property, while the tax-exempt entity typically received an implicit fee for participating in the arrangement and continued to control the operation of the property.

Section 470 suspends the deduction of losses related to "tax-exempt use property" in excess of the income or gain from that property. Tax-exempt use property includes property that is leased to a tax-exempt entity. Importantly, however, as a result of the application of section 168(h)(6), tax-exempt use property also includes property (whether or not leased) owned by a partnership that (1) has as partners both taxable and tax-exempt entities (including foreign persons) and (2) makes allocations to the tax-exempt partners that are not "qualified." As a result, a partnership that has a combination of taxable and tax-exempt (including foreign) partners and that makes nonqualified allocations is potentially subject to section 470, even if the partnership does not lease any property and even if the partnership is not engaged in a SILO-like transaction.

In the pass-thru context, section 470 applies to property acquired after March 12, 2004. The IRS and Treasury, however, have indicated that, for tax years beginning before January 1, 2006, the IRS will not apply section 470 to disallow losses associated with property that is treated as tax-exempt use property solely as a result of the application of section 168(h)(6).²

C. Previous Submission by the Tax Section

In June 7, 2005, the Tax Section of the American Bar Association submitted a letter to the distinguished Chairs and Ranking Members of the House Committee on Ways and Means and the Senate Finance Committee expressing concerns regarding the application of section 470 to pass-thru entities.

In our previous submission, we expressed our strong concern that section 470 applied in the partnership context far more broadly than necessary to achieve the Government's "anti-SILO" objective. Our previous submission provided support for why we did not believe Congress intended section 470 to apply so broadly, as well as examples of the kinds of common business arrangements that could be inappropriately subject to the loss deferral regime.

In our previous submission, we made a number of recommendations that were intended both (1) to protect the Government's interest in preventing the "next generation" of SILO transactions through partnerships and (2) to allow taxable and tax-exempt parties to continue to undertake legitimate business transactions through partnerships without inappropriately being subject to the loss deferral rules of section 470. Although there were numerous aspects to the recommendations, the core recommendation focused on excluding partnerships from the application of section 470 where a tax-exempt partner did not "use" or "control" the property following acquisition of the property by the partnership. While we recognize that there are difficulties in applying the concepts of "use" and "control" in the context of certain limited types of properties, we continue to believe that this basic approach is most effective in distinguishing legitimate

² See Notice 2006-2, 2006-2 I.R.B. 278, and Notice 2005-29, 2005-1 C.B. 796.

arrangements from those that resemble SILOs. Further, from a tax policy perspective, it provides an objective standard that, in most cases, can easily be administered.

D. Section 6 of the Technical Corrections Act

Section 6 of the Technical Corrections Act takes a different approach to addressing how section 470 applies to pass-thru entities that are not engaged in covered leasing transactions. This approach would exclude some legitimate business arrangements from the application of the loss deferral regime. In this regard, we commend the drafters for recognizing the need to narrow the application of section 470. Nonetheless, we are very concerned that the Technical Corrections Act does not go far enough in excluding those entities that are not engaged in the kinds of SILO transactions Congress considers to be abusive. We also are concerned that the approach reflected in the Technical Corrections Act will engender tremendous uncertainty as to both the scope and operation of section 470 in the pass-thru context, in contravention of sound tax policy. Thus, we respectfully encourage the drafters to reconsider the suggested approach that we described in our previous submission.

We appreciate, however, the interest in securing expeditiously a legislative solution to the problems associated with the application of section 470 to pass-thru entities. We also understand that the drafters of the Technical Corrections Act would like this solution to “mirror” the exceptions contained in section 470(d) for “legitimate” leases to the extent possible and are appreciative of the opportunity to provide comments on the Technical Corrections Act before it moves further in the legislative process. Thus, while the discussion below summarizes significant problems with the approach reflected in the Technical Corrections Act, it also contains suggestions as to how that approach could be modified so as to protect the Government’s interests in deterring “synthetic” SILOs, while not inappropriately subjecting a large number of legitimate arrangements to the loss deferral rules.

1. Scope of Loss Deferral

The Technical Corrections Act would amend section 470 to expand the portion of a pass-thru entity’s property that can be subject to the loss deferral rules. Section 168(h)(6) treats only the tax-exempt entity’s “proportionate share” of the entity’s property as tax-exempt use property. The Technical Corrections Act would eliminate the “proportionate share” rule and treat *all* property of a pass-thru entity (not otherwise excepted from section 470) as tax-exempt use property for purposes of section 470 if *any* portion is treated as tax-exempt use property for purposes of section 168(h)(6). This approach has the practical effect of causing all of the losses with respect to a particular property to be deferred, even if the tax-exempt partner’s share of partnership items with respect to such property is extremely small. This result is unduly harsh, particularly to the extent that section 470 continues to apply to many legitimate pass-thru entities that are not involved in SILO arrangements. Further, expanding the scope of the disallowance retroactively (as the Technical Corrections Act proposes to do) would be inconsistent with sound tax policy. Thus, we recommend that only the tax-exempt entity’s share of property be treated as tax-exempt use property.

2. Exception for Non-Depreciable Property

The Technical Corrections Act also provides two new exceptions to the definition of tax-exempt use property in situations in which property would otherwise be considered tax-exempt use property solely by reason of section 168(h)(6). One of these exceptions is for property that is not of a character subject to the allowance for depreciation. We strongly support this exception for the reasons set forth in our previous submission. We note, however, that the Joint Committee on Taxation's description of the Technical Corrections Act (JCX-48-06) (the "JCT Description") indicates that, to qualify for the exception, property must be both non-depreciable and non-amortizable. Presumably, the reference to property that is subject to amortization is intended to capture amortizable section 197 intangibles, which is consistent with the inclusion of such property in section 470(c)(2)(B)(ii). This reference, however, also raises questions with respect to other property that may be subject to amortization, such as bonds with amortizable bond premium under section 171. Bonds with amortizable bond premium generally are not thought to be of a character subject to the allowance for depreciation and should not be subject to section 470. For this reason, clarification as to the scope of the reference to "amortizable property" in the JCT Description would be helpful.

3. Exception Based Upon the Economic Characteristics of the Partnership

The second new exception (the "Two-Part Exception") is for partnerships that meet both of two fairly complex requirements – the "no set aside" requirement and the "no option to purchase at other than value" requirement -- with respect to the property for the taxable year. The Two-Part Exception is the exception upon which many thousands of legitimate pass-thru entities that hold depreciable property would have to rely in order to escape the application of the anti-SILO loss deferral rules.

a. General Concerns

As is explained below, the Two-Part Exception focuses on the economic characteristics of the arrangements among partnerships, partners, lenders, and potentially others. As the Government has previously recognized in another context, "[s]ubchapter K is intended to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax."³ This statement gives explicit recognition to the flexibility of the partnership entity and the fact that taxpayers may engage in a myriad of diverse economic arrangements through partnerships. We cannot emphasize enough the difficulty in anticipating the economic terms that taxpayers may enter into, or may have entered into, in advancing legitimate business interests in connection with a partnership. Thus, any rule that focuses exclusively on the economic characteristics of partnership arrangements, such as the Two-Part Exception, will inevitably capture many legitimate partnerships that have nothing to do with SILOs. For this reason, we believe that, if such an approach is

³ Treas. Reg. § 1.701-2(a).

employed, it needs to be combined with a consideration of other characteristics of the arrangement. Otherwise, numerous legitimate taxpayers will be subject to loss deferral rules that Congress intended to apply only to abusive arrangements. We discuss alternative approaches and rules for consideration after the discussion of issues arising in connection with the Two-Part Exception.

b. Particular Concerns Regarding the "No Set Aside" Requirement

The "no set aside" requirement focuses on whether, at any time during a taxable year with respect to any property owned by the partnership, funds are (1) subject to certain arrangements (such as a defeasance arrangement, a letter of credit collateralized with cash or cash equivalents, or a loan by a tax-exempt partner or the partnership to any taxable partner, the partnership, or any lender, among others) or (2) set aside or expected to be set aside, to or for the benefit of a taxable partner or any lender, or to or for the benefit of any tax-exempt partner to satisfy any obligation of the tax-exempt partner to the partnership, any taxable partner, or any lender. In the case of funds *outside of the partnership* (i.e., funds held by a party other than the partnership that are set aside to satisfy an obligation described in the prior sentence), the "no set aside" requirement requires that no amount be subject to an arrangement or set aside in this manner at any time during a taxable year. With respect to funds held by the partnership, it would be permissible for funds to be subject to an arrangement or set aside (or expected to be set aside) by the partnership to or for the benefit of a partner or lender as of any date during the year in an amount equal to the greater of:

- (1) 20 percent of the "aggregate debt of the partnership" (which term is not defined); or
- (2) the sum of (a) 20 percent of the taxable partners' capital accounts determined under the rules of section 704(b) and (b) 20 percent of the taxable partners' share of the recourse liabilities of the partnership determined under section 752.

The Technical Corrections Act provides that funds that are set aside for less than 12 months would not be taken into account in determining whether the "no set aside" requirement is met. It further provides that funds would not be treated as "set aside" if such funds "(I) bear no connection to the economic relationships among the partners, and (II) bear no connection to the economic relationships among the partners and the partnership."

The "no set aside" requirement appears designed to mirror the "no defeasance" rule set forth in section 470(d) with respect to leases. Section 470(d) provides that a lease that has certain characteristics is not subject to the loss deferral rules, presumably because those characteristics are inconsistent with SILO transactions. One of these characteristics is that the tax-exempt lessee has not monetized more than an allowable amount of its lease obligation (including any purchase option) pursuant to an arrangement, set aside, or

expected set aside that is to or for the benefit of the taxpayer or any lender, or is to or for the benefit of the tax-exempt lessee. While looking to a lack of defeasance may make sense in distinguishing a “good” leasing arrangement from a SILO leasing arrangement, such an approach is inherently difficult to apply in the partnership context and cannot be structured in such a manner so as to accurately separate legitimate pass-thru entities from those that might be structured in the future as synthetic SILOs.⁴ Specific concerns and suggestions with regard to this requirement include the following:

- The exception establishes a “reasonable person” standard for determining when funds are set aside or expected to be “set aside for the benefit” of one of the relevant parties. In the context of leases, money set aside for the benefit of the lessor must be “targeted” towards the lessor in some way in order for a reasonable person to determine that the funds are impermissibly set aside. By contrast, all partnership funds are held for the eventual benefit of those with an economic stake in the partnership – including partners and lenders. Thus, in undertaking the required analysis for funds held by the partnership, the “for the benefit of” portion of the test does not meaningfully affect the inquiry. Instead, the primary question will relate to what it means for funds to be “set aside.” Given that partnerships may hold significant cash for many purposes, it is imperative that taxpayers have detailed guidance allowing them to determine when funds are considered to be set aside in a manner that violates the “no set aside” requirement. Presumably, the “no set aside” requirement, as applied to funds held by a partnership, is intended to capture only funds that have been isolated, such that they will not be available for use in connection with the business of the partnership, and that are earmarked either for distribution to partners or payment to creditors.⁵ Clarifying the meaning of the requirement would help both the taxpayers and the IRS apply this provision. In fact, given the stakes of loss deferral for all partners, pass-thru entities need immediate clarity as to how they can establish with certainty that funds are not considered to be set aside for an impermissible purpose.
- Establishing the purpose for which particular funds are set aside raises tracing and fungibility concerns and could impose tremendous administrative burdens on both taxpayers and the Government.

⁴ As was indicated in our previous submission, we are not aware of any pass-thru entities that have been used to replicate the economics of a SILO transaction.

⁵ As is discussed below, we similarly believe that, if the reference to “lenders” is retained in section 470(e)(2), the statute should apply only with respect to “arrangements” and “set asides” where the loan serves to support repayment of the investment of the taxable partner. Also, sinking funds to redeem partners are common business structures used in many legitimate arrangements. Thus, the existence of a sinking fund should not necessarily be viewed as determinative of a SILO arrangement. Nonetheless, we understand that the presence of a sinking fund, in conjunction with other factors, could be troubling to the Government. This illustrates the problems with subjecting a partnership with depreciable property to section 470 merely because it fails the “no set aside” requirement, without examining the totality of the arrangement.

- The blanket inclusion of partnership lenders as parties for whom “arrangements” and “set asides” are prohibited sweeps in numerous legitimate partnership arrangements.

We assume that lender arrangements are included to address two primary situations. In one situation, a taxable partner would contribute significant cash to the partnership and simultaneously would borrow a like amount of funds. The tax-exempt partner would bear the risk with respect to the debt, either by lending the funds directly to the taxable partner or by guaranteeing debt advanced to the taxable partner by a third-party lender. Repayment of the debt by the taxable partner would be contingent on the taxable partner receiving back its investment in the partnership.⁶ In a second situation, the taxable partner may advance minimal funds to a partnership, with the majority of the acquisition proceeds for the property being borrowed by the partnership from an unrelated lender. In order to accrue significant deductions in this situation, the taxable partner would be required to enter into a guarantee or some similar arrangement with respect to the debt. To counteract the risk associated with the guarantee, however, the partnership would set aside significant funds for repayment of the debt so as to ensure that the taxable partner is never called upon to satisfy its guarantee obligation.

As an initial matter, we do not think that the second situation should create any concern for the Government. Treas. Reg. § 1.752-2(j)(3) provides that “[a]n obligation of a partner to make a payment is not recognized if the facts and circumstances evidence a plan to circumvent or avoid the obligation.” It is hard to see how a scenario that satisfies the “set aside” requirement in section 470(e)(2) would not run afoul of this provision.⁷

We also believe that existing authority provides the Government with significant weapons to attack the first situation. Depending on the facts, the lending arrangement may be disregarded altogether, so that the tax-exempt party would be

⁶ In the third-party lender situation, the tax-exempt partner would repay the debt pursuant to the guarantee.

⁷ As a result, the taxable partner would not have sufficient adjusted basis under section 705 to take into account significant losses, as section 704(d) would limit the allowance of such losses. Similarly, with minimal capital invested by the taxable partner, and presumably significant capital being contributed by the tax-exempt partner to provide for the funds that would be set aside and that would secure the partnership debt, it would not seem possible to allocate significant losses to that taxable partner under section 704(b). First, the taxable partner would not have contributed significant capital to justify the allocation of losses. Similarly, it would not seem possible to generate nonrecourse deductions under Treas. Reg. § 1.704-2(c) that might be allocated to the taxable partner in this situation. If both the property and the funds secured the debt, the total basis (or book value) of all property securing the debt would not fall below the amount of the debt (*i.e.*, because the funds would retain their basis (or book value)). Thus, no nonrecourse deductions would result from depreciation of the property. See Treas. Reg. § 1.704-2(b)(2) (“partnership minimum gain” is the amount by which a nonrecourse liability exceeds the adjusted basis (or book value) of partnership property that the debt encumbers); Treas. Reg. § 1.704-2(c) (“nonrecourse deductions” must be attributable to a net increase in partnership minimum gain during the year).

treated as the person contributing the funds.⁸ Of equal or greater significance, the regulations under section 704(b) would certainly take such an arrangement into account in determining the allocation of losses under the partnership agreement. We think it is highly unlikely that section 704(b) would permit a partner to be allocated losses where the partner is protected from loss as a result of a lender arrangement.⁹

Given the means already available to the Government to deal with lender arrangements and set asides, the inclusion of such arrangements seems unnecessary. Further weighing against the inclusion of these lender arrangements and set asides is the multitude of legitimate lender arrangements that occur

⁸ See Rev. Rul. 72-135, 1972-1 C.B. 200 (nonrecourse loan by general partner to limited partner for limited partner to purchase partnership interest recast as a contribution to capital by general partner). Cf. *Knetsch v. U.S.*, 364 U.S. 361 (1960) (no valid indebtedness in deferred annuity savings investment where annual borrowings kept net cash value at a de minimis amount; lending was, in substance, a rebate of a substantial part of the interest payments); *Bussing v. Commissioner*, 88 T.C. 449 (1987) (loan disregarded in sham leasing arrangement where note payments and rental obligation offset each other), *supplemental opinion*, 89 T.C. 1050 (1987); *HGA Cinema Trust v. Commissioner*, 950 F.2d 1357 (7th Cir. 1991) (same), *cert. denied*, 505 U.S. 1205 (1992); *Compare Van Roekel v. Commissioner*, T.C. Memo 1989-74 (note in sale-leaseback transaction determined to be valid where debtor was unconditionally liable for payments and the form was respected in early years of the arrangement; court noted this was a "close case").

⁹ Treas. Reg. § 1.704-1(b)(2)(ii)(f) states that, for purposes of section 704(b), the partnership agreement includes all agreements among the partners, or between one or more partners and the partnership, concerning the affairs of the partnership and responsibility of partners, whether oral or written, and whether or not embodied in a document referred to by the partners as the partnership agreement. Thus, in determining whether distributions are required in all cases to be made in accordance with the partners' positive capital account balances . . . , and in determining the extent to which a partner is obligated to restore a deficit balance in his capital account . . . , all arrangements among partners, or between one or more partners and the partnership relating to the partnership, direct and indirect, including puts, options and other buy-sell agreements, and any other 'stop-loss' arrangement, are considered to be part of the partnership agreement. (Thus, for example, if one partner who assumes a liability of the partnership is indemnified by another partner for a portion of such liability, the indemnifying partner (depending on the particular facts) may be viewed as in effect having a partial deficit makeup obligation as a result of such indemnity agreement.)

Under Treas Reg. § 1.704-1(b)(2)(ii)(a), in order for an allocation to be respected as having economic effect, "it must be consistent with the underlying economic arrangement of the partners." In other words, any economic benefit or economic burden that corresponds to an allocation must inure to the benefit or detriment of the partner to whom the allocation is made. If the lender arrangement is taken into account as part of the partnership agreement, so that the taxable partner is considered to be protected from loss with respect to its investment for purposes of analyzing allocations, the section 704(b) regulations would not permit an allocation of losses to the taxable partner. We note that, in *Van Roekel v. Commissioner*, T.C. Memo 1989-74 (discussed *supra* note 8), the court found that, although the indebtedness in that case would be respected for federal tax purposes, the taxpayer would be viewed as protected from loss with respect to such indebtedness.

everyday in the partnership context which would unfairly subject a partnership to loss deferral under section 470. For instance, many loans that are subject to securitization may not be prepaid.¹⁰ The only way to effectively pre-pay such a loan is to defease the obligation. It appears, however, that if a partnership utilizes “in substance” defeasance or “legal” defeasance, the partnership will fail section 470 unless it can satisfy one of the 20-percent safe harbors for “inside” defeasance.¹¹ As another example, where a partner guarantees debt of a partnership, it is not at all unusual for the lender to require that the guarantor post some amount of collateral to secure its guarantee obligations. This often will take the form of a letter of credit or some other arrangement that would be impermissible under the terms of the amendment. Because this arrangement would relate to funds held outside the partnership, the 20-percent safe harbor would not be available. The universe of analogous arrangements that raise troubles in this regard is too numerous to catalogue.

Because the references to “lenders” sweeps in numerous legitimate transactions in situations where the Government’s interest already is significantly protected by existing rules and authority, we believe that the references to “lenders” in section 470(e)(2) should be eliminated. If these references are not eliminated, we believe that the situations in which lender arrangements are considered should be significantly limited so as to refer only to situations where the principle purpose of the loan is to support repayment, directly or indirectly, of the investment of the taxable partner.

- “Arrangement” includes a loan by a tax-exempt partner or the partnership to any taxable partner, the partnership, or any lender. These kinds of arrangements are very common. For example, if a partnership is having financial difficulty, partners often will fund operations through debt rather than equity so as to preserve claims for repayment in bankruptcy or other collection actions. Partners (including tax-exempt partners) also may lend funds to employees or service providers of a partnership in order to allow such persons to acquire interests in partnerships and thereby “incentivize” such persons to contribute to the success of the business. Loans by partnerships to partners also are extremely common. (Indeed, the Treasury regulations contain specific rules to address such loans.¹²)

¹⁰ See B. Rubin, A. Whiteway, and J. Finkelstein, *Tax Planning for Conduit Loan Defeasance Transactions, Including Like Kind Exchanges*, 9 J. of Passthrough Entities 15 (2006).

¹¹ Significantly, even though the partnership would no longer be treated as the borrower for federal tax purposes with respect to debt that it legally defeases, section 470 may nevertheless be applicable. This is because the reference to “lender” in the amendment does not refer only to a lender of the partnership, as determined for federal tax purposes. Instead, the provision literally seems to apply where the partnership provides for the defeasance of an obligation of any borrower to *any* lender. As is discussed below, proposed new section 470(e)(2)(D)(ii) provides the only limitation on arrangements with respect to lenders; under this provision, such arrangements are ignored only if the funds bear no connection to the economic relationship (1) of the partners or (2) among the partners and the partnership. See *infra* text accompanying note 12.

¹² See, e.g., Treas. Reg. § 1.752-2(c)(1) (partner generally bears “economic risk of loss” with respect to loans made by such partner or related person); Treas. Reg. § 1.752-2(d) (*de minimis* exception applicable

Further, where one partner fails to fund a capital call, it is very common for another partner to contribute funds for that partner, with the operative documents treating the advance as a loan between the partners. Where the partner making the advance is a tax-exempt partner and the partner who failed to make the advance is taxable, presumably the arrangement would constitute impermissible "outside" defeasance, thereby subjecting the partnership to section 470. Consistent with our recommendation above, we believe that, if loans continue to be treated as "arrangements," such treatment should follow only where the principal purpose of the loan is to support repayment, directly or indirectly, of the investment of the taxable partner.

- Where a partnership sells property and does not instantaneously distribute such amounts, the sales proceeds seemingly would be treated as set aside for the benefit of the partners (including taxable partners). The amendment includes a 12-month safe harbor rule to help alleviate this problem. This rule, however, may not apply when a partnership repeatedly sells assets. In this situation, the "set aside" amount may never fall to zero in a 12-month period because, by the time that the proceeds from one sale are distributed, the proceeds from the next sale have already been received.¹³ This is of particular concern where a partnership is in the process of winding up its affairs and liquidating. Thus, consideration should be given to deeming a partnership to satisfy the "no set aside" requirement if it has adopted a plan of liquidation and distributes all of its assets within a few years of adopting such plan.¹⁴ A partnership that is near the end of its life would not be an attractive vehicle for a SILO, given the limited period during which deductions would be generated. Nonetheless, even with such an exception, it is important to recognize that entities that frequently sell assets but that are not in the process of winding down still could be inappropriately subject to the loss deferral regime.
- At a minimum, the "20-percent" allowable partnership amount should be increased to a much higher percentage. Much larger amounts (approaching 100 percent) were "defeased" in the SILO transactions with which Congress was concerned in enacting section 470 because substantial defeasance was necessary

to loans made or guaranteed by a partner or related person); and Treas. Reg. § 1.704-2(i) (providing that "partner nonrecourse deduction," *i.e.*, deductions arising from otherwise nonrecourse loans made by partners or related persons, must be allocated to the partner that bears the economic risk of loss with respect to such loans).

¹³ In order to qualify for the safe harbor, funds cannot be set aside, or subject to an arrangement, for 12 months or more. Thus, questions are raised as to the availability of the safe harbor when a partnership sells multiple properties over a period of time; even though the partnership may distribute funds from each property sale within a relatively short period of time following the sale, it may have a positive amount "set aside" for a period of more than 12 months.

¹⁴ *Cf.* section 332(b)(3) (permitting a corporate shareholder to receive assets from a subsidiary corporation tax free in connection with the liquidation of the subsidiary if, among other things, the subsidiary distributes all of its assets within 3 years of the close of the taxable year during which the first liquidating distribution is made).

in order to make the transactions attractive. It is hard for us to point to a specific benchmark for what would be a reasonable allowable partnership amount. The fact that a partnership has a significant amount of liquid assets is in no way determinative that it is being used to replicate a SILO; indeed, many current joint ventures and other pass-thru entities have significant funds on hands for a variety of reasons, yet we are not aware of any such entities that have been used to replicate a SILO arrangement.

Given the extremely broad parameters for what is caught by the amendment, we view the allowable partnership amount as a "rough justice" provision designed to give a chance to those innocent parties who, for legitimate reasons, enter into (or have entered into) an otherwise impermissible arrangement or set aside. Whether a situation falls below or above any allowable partnership amount necessarily will be "luck of the draw," depending on the characteristics of the partners and the partnership.¹⁵ Given the extremely broad parameters of what constitutes an impermissible arrangement or set aside and the numerous legitimate partnerships that will fall within these parameters, we strongly urge the Government to consider how high this threshold could go before the Government's interests are realistically compromised. Similar thought should be given in the context of outside defeasance, as the provisions defining what constitutes outside defeasance also are so broad as to encompass many very common partnership arrangements. In many situations, the allowable partnership amount will serve as the only way for legitimate partnerships to avoid loss disallowance under section 470.

- The meaning of the rule that provides that funds would not be treated as "set aside" if they bear no connection to the economic relationships among the partners or to the economic relationships among the partners and the partnership is unclear. We understand that this rule is viewed as necessary due to the lack of any designation as to who can hold funds pursuant to an arrangement or set aside for the benefit of (1) a taxable partner, the partnership, or any lender or (2) a tax-exempt partner to satisfy any obligation of such tax-exempt partner to the partnership, any taxable partner, or any lender. For example, without this rule, a partnership could become subject to section 470 by virtue of an unrelated third party taking out a letter of credit to secure a loan to a taxable partner of the partnership, even though the loan has absolutely nothing to do with the partnership.

¹⁵ Because, under one test, the "allowable partnership amount" is measured by reference to taxable partners' capital accounts and their share of recourse debt, the test may not assist legitimate partnerships from escaping the inappropriate application of section 470 when there are insignificant taxable partners participating. Similarly, because, under the other test, the "allowable partnership amount" is measured by reference to partnership debt, partnerships that are not highly leveraged would have little leeway accorded by this test. Separately, defeasance of a loan relating to a single property in a large multi-property partnership may not create problems under the 20-percent safe harbor, whereas defeasance of a loan relating to a single property in a single-property partnership is much more likely to give rise to an arrangement that falls outside of the 20-percent safe harbor.

The “no connection to economic relationships” language obviously is very restrictive and seemingly would not apply in situations in which a party may have a very tangential connection to the economic relationship among the partners or the partners and the partnership. In addition, the language would not appear to apply to an arrangement or set aside that has a connection to the economic relationship among the partners, but in a context that is wholly unrelated to the partnership. In today’s investment world, investors may come together in numerous transactions and in a multitude of circumstances. For example, a taxable party and a tax-exempt pension fund may come together as partners in one deal, while, in another deal, the taxable party (or an affiliate) may undertake syndicated financing for a project where the same tax-exempt pension fund participates as a lender. The loan has nothing to do with the joint investment of the parties in the partnership, but the loan does bear a clear connection to the economic relationship of the taxable party and tax-exempt pension fund. There are an endless number of similar scenarios that have nothing to do with SILOs.

In order to prevent such arrangements from causing legitimate partnerships to be subject to loss deferral under section 470, it is necessary to more specifically define the arrangements and set asides that do not, in a real and substantial way, implicate the relationships among the relevant parties “in a capacity” that relates to the partnership.

- In addition, the rule relating to arrangements and set asides contemplates relationships with lenders, although the exclusion gives no indication as to how lenders are taken into account. Presumably, arrangements or set asides with respect to lenders are only taken into account where such arrangements affect the economic relationships among the partners or among the partners and the partnership.¹⁶ Nonetheless, the existing rule engenders significant uncertainty and confusion. For instance, suppose that a tax-exempt partner owes significant funds to a bank, and a taxable partner in the same partnership owns a small number of shares of that bank. The bank requires that collateral be set aside for the loan. The loan is of such a size that, if it were to become uncollectible, it could affect the price of the bank’s stock, thereby indirectly affecting the economic well-being of the taxable partner. Without further guidance, this arrangement could be viewed as having some (albeit *de minimis*) effect on the economic relationship of the partners (assuming that the parties could even detect that this arrangement exists).
- Finally, the amendment operates with respect to “funds” that are subject to an “arrangement” or that are “set aside.” We note, however, that the amendment does not define “funds” for purposes of this provision. While “funds” would seem to denote cash, we anticipate that the drafters may also intend that marketable securities fall within the definition of “funds.” The inclusion of

¹⁶ See *supra* note 11.

marketable securities could create problems in a number of situations that in no way implicate the concerns present with respect to SILOs.

One situation in particular exists with respect to REITs and their “umbrella” partnerships (“UPREIT partnerships”).¹⁷ Most REITs hold their property through an UPREIT partnership that has unrelated third-party partners. The partners may be either taxable or tax-exempt. An outside investor in an UPREIT partnership generally is entitled to have its partnership interest redeemed either for cash or stock of the REIT that is equal to the fair market value of the partnership interest. The REIT generally will stand ready to issue stock to satisfy the redemption obligation. A REIT obviously has a virtually unlimited ability to issue its own stock, so it is quite easy to see how the Government might argue that the arrangement with respect to UPREIT partners gives rise to an impermissible “set aside.” Nonetheless, such arrangements in no way create concerns implicated by SILOs.¹⁸

c. Particular Concerns Regarding the “No Option to Purchase at Other Than Value” Requirement

In order to meet the “no option to purchase at other than value” requirement, no tax-exempt partner can have, at any time during a taxable year, an option to purchase (or to compel distribution of) partnership property or a direct or indirect interest in the partnership other than at the fair market value of such property or interest at the time of the purchase or distribution. In addition, the partnership and the taxable partners cannot have an option to sell (or to compel distribution of) partnership property or a partnership interest to any tax-exempt partner at any time other than at the fair market value of such property or interest as determined at the time of the sale or distribution. Treasury would have the authority to issue regulations allowing the fair market value of partnership property or a partnership interest to be determined by formula “when the value is determined based on objective criteria that are reasonably designed to approximate the fair market value of such property at the time of the purchase, sale, or distribution.”

The “no option to purchase at other than value” requirement appears to be based upon concerns that, in the typical SILO transaction, a tax-exempt lessee is assured that it can purchase the property it previously had sold for a predetermined amount at the end of the lease term. Although looking to a tax-exempt entity’s ability to purchase property for an amount other than value may make sense in attempting to distinguish a “good” leasing

¹⁷ Also, analogous structures (typically referred to as “Public LLCs” or “Pubco” structures) have become increasingly commonplace in corporate America, with a number of companies having gone public in the last year using this structure.

¹⁸ We note that there also could be significant problems presented where a partnership holds, along with property that is subject to an allowance for depreciation, stock in a corporation whose stock becomes publicly traded. If a partnership decides that it will not immediately distribute such publicly-traded stock to the partners (possibly because it is prohibited from doing so for regulatory reasons), but also determines that it will ultimately distribute, rather than sell, the stock, this action seemingly could create an impermissible “set aside.”

arrangement from a SILO leasing arrangement, such an approach is more problematic in the pass-thru entity context, given that pass-thru entities utilize different kinds of option arrangements for a variety of different business reasons. Further, it may be very difficult, if not impossible, for pass-thru entities to restructure existing options, puts, and other similar agreements, given that this involves renegotiating and modifying the economic agreement among the parties. Specific concerns and suggestions with regard to the “no option to purchase other than at value” requirement include the following:

- Many options determine the fair market value of property at the time of exercise based upon formulae. Further, there are many different kinds of formulae that are used. Although the Technical Corrections Act provides Treasury with authority to “allow” the use of formula options, it is unclear at this point what kinds of formulae will be acceptable. Clear rules as to what kinds of formula options satisfy the “no option to purchase at other than value” need to be provided before section 470 is applied to any pass-thru entity that is not engaged in a covered leasing transaction. Deferring resolution of this issue until such time as regulations may be issued will create considerable uncertainty as to what extent taxpayers are subject to section 470, will engender significant compliance concerns, and is inconsistent with the sound administration of the tax laws.
- The application of the fair market value analysis is unclear in many contexts relating to partnerships. The amendment makes reference to fair market value only in the context of the property being acquired from the partnership or the partnership interest being acquired from another partner. The analysis, however, in the partnership context is more complicated than this. Unlike in the leasing context, where the consideration that will be conveyed in exercising the option almost always will be cash, for partnerships, a partner often will transfer its partnership interest in exchange for property received in redemption. In this situation, the Government presumably will want to ensure that (1) the amount of property being distributed is determined by reference to fair market value, and (2) the credit given to the partner for the partnership interest being redeemed similarly is fair market value. Manipulation of either side of the equation could upset the protection that the Government is looking to obtain. This raises the very difficult question, however, as to how one determines the fair market value of a partnership interest. That is, does one look to what a willing buyer would pay to a willing seller when bargaining at arm’s length, or does one instead look to the liquidation value of the interest that is being redeemed? The Government has previously struggled with this analysis, and, in one context, has given taxpayers the ability to choose either method.¹⁹ While “liquidation value” often (although not always) is used to measure economic entitlement in a liquidating distribution,²⁰ this amount rarely will reflect the fair market value that parties

¹⁹ Prop. Reg. § 1.83-3(l); Notice 2005-43, 2005-24 I.R.B. 1221.

²⁰ In determining whether a partnership’s allocations have economic effect, the regulations generally require that liquidating distributions with respect to a partner must be in accordance with that partner’s positive capital accounts. Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2). This requirement, however, is not violated if “all or part of the partnership interest of one or more partners is purchased (other than in connection with

would derive where a willing buyer and seller are negotiating for the sale of a partnership interest, as these parties will consider factors like voting control, liquidity of the investment, etc., and the Government has recognized this fact.²¹ Would this dichotomy result in taxpayers being required to undertake a different fair market value analysis for the partnership interest depending on how the interest is transferred? Such an analysis would seem to undercut the conclusion that taxpayers really can determine the "fair market value" of a partnership interest. Guidance with respect to this issue obviously would be of great importance in applying section 470.

- Problems also could arise in the context of preferred partnership interests that are not redeemable for a period of time without payment of a penalty. Suppose that a foreign (*i.e.*, tax-exempt) partner is the general partner of a partnership. Taxable partners hold nine-percent cumulative preferred partnership interests that are mandatorily redeemable in ten years. The partnership, which is managed by the foreign general partner, may redeem the preferred interests earlier by paying a penalty equal to an additional one-percent percent cumulative return to the partners determined through the redemption date. Would the payment of the penalty cause the foreign partner to be treated as acquiring an indirect interest in the partnership at other than fair market value (*i.e.*, the value of a nine percent preferred partnership interest) or is the penalty provision taken into account in determining the value of the partnership interest? One would hope that the answer is the latter, given that the penalty provision is an inherent feature of the partnership interest, but this answer is by no means clear under the statute.²²
- It is common for a partnership or partner promoting a partnership to reacquire a partnership interest from a service provider partner when the service provider ceases to provide services for the partnership. The acquisition price may be the amount the service provider paid for its interest, book value, or some other amount that does not reflect the fair market value of the interest. The service provider partner does not receive the full fair market value simply because the arrangement was structured so as to deter the service provider partner from terminating the employment relationship. Although this kind of arrangement does not present SILO concerns, it arguably violates the fair market value option

the liquidation of the partnership) by the partnership or by one or more partners . . . pursuant to an agreement negotiated at arm's length by persons who at the time such agreement is entered into have materially adverse interests and if a principal purpose of such purchase and sale is not to avoid" the principle that partners must receive the economic benefit and bear the economic burden relating to allocations. Treas. Reg. § 1.704-1(b)(2)(ii)(b) (flush language).

²¹ See *supra* note 19.

²² Note that this question also raises issues that relate to the discussion immediately above. That is, from a willing buyer/willing seller valuation perspective, some discount for the penalty provision likely would be taken given the probability that the interest will not be redeemed prior to the end of ten years. Presumably, no such discount would be applied once it became clear that the redemption option would be exercised early, so that penalty provision clearly would apply. Issues such as this, however, create significant confusion.

requirement because a tax-exempt partner's indirect interest (or direct, where a tax-exempt partner acquires directly the interest) may be increased as a result of the exercise of the option to reacquire the partnership interest from the service provider.

- The fair market value option requirement also provides the potential for partners to use section 470 to their benefit. For instance, assume that two small partners, one taxable and one tax-exempt, are bargaining to have their partnership interests redeemed. In order to inflate the redemption price, the taxable partner threatens to issue a non-fair market value option to the tax-exempt partner to acquire the taxable partner's interest. Such an option could cause the partnership to become subject to loss deferral under section 470, which would adversely affect all of the taxable partners. This possibility could force the partnership to succumb to the economic blackmail of the partners who are bargaining for redemption, such that the partnership would pay those partners an inflated amount for their partnership interests. This result obviously is not one that the tax system should encourage.

4. Issues Regarding Tiered Partnerships

The amendment grants regulatory authority to "provide for the application of [section 470] to tiered and other related partnerships." The issues regarding the application of section 470 in the tiered partnership context are so significant that we believe that the provision literally will be impossible to apply in many, if not most, situations involving partnerships with taxable and tax-exempt partners.

A very significant portion of the universe of partnerships with taxable and tax-exempt partners involves investment partnerships where the tax-exempts are merely passive financial investors in a "fund" partnership that is managed by a third-party promoter. The "fund" partnership often will invest in the underlying property or business that is the subject of its investment through one or more tiers of partnerships.²³ It is not unusual for one fund to joint venture with another fund with respect to a particular investment. This may occur from the inception of an investment or during the life of an investment, where the original fund wants to diversify its risk or capture part of its return with respect to the investment. Also, many times, one fund will actually invest as a partner in another fund. There often will be different properties and partners involved at each tier in the investment structure.

Numerous additional reasons exist for tiered partnerships, including a desire to isolate certain properties in a portfolio for partial investment by a different group of investors, structural, as opposed to legal, subordination in lending and equity arrangements, regulatory reasons, and state and foreign tax planning, just to name a few. Given the frequency with which taxable and tax-exempt partners join together in tiered

²³ The exception in the Technical Corrections Act for nondepreciable property will not remove the partnership from the application of section 470 to the extent (as is common) the fund invests in non-corporate entities that hold operating businesses or other property (such as real estate) that is subject to the allowance for depreciation.

partnership arrangements, it is absolutely imperative that parties have clear guidance in any enacted legislation as to how the rules of section 470 should apply in this context. Some of the problems arising in the tiered context – for both taxpayers and the Government -- are as follows:

- It is not clear how a lower-tier partnership will obtain the information necessary to determine whether and how section 470 applies. Under the amendment, section 470 applies on a property-by-property basis, so the partnership that holds the direct interest in the property will have to determine the extent of loss disallowance. Often, this partnership will have no access to information regarding the ultimate partners, whether there is a non-fair market value option at any level in the tiered partnerships, whether an arrangement or set aside exists at any level in the tiered partnerships, and whether non-qualified allocations exist at any level in the tiered partnerships. Lower-tier partnerships could take the conservative position that section 470 applies to all property and include information on the Schedule K-1s to this effect. This obviously would be a reporting nightmare. Similarly, if there are multiple chains of partnerships flowing from the ultimate properties, and section 470 applies because of a violation in one of the chains, how will partners in another chain know to apply section 470 where all parties in that chain have arranged their affairs so as to comply with section 470?
- It is not clear how the no “arrangement” or “set aside” requirements apply in a tiered partnership structure. For instance, is the 20-percent safe harbor available in a tiered arrangement where funds may be set aside for distribution or for the benefit of a lender in one or more upper-tier partnerships? The 20-percent safe harbor is not available in “outside defeasance arrangements” where the funds set aside are not “partnership property.” Does “partnership property” refer only to funds held by the partnership where the property that potentially is subject to 470 resides, or does it refer to property anywhere in the chain between the property and the ultimate partners? If the 20-percent safe harbor cannot apply in this situation, the safe harbor will be of very little use in escaping the inappropriate application of section 470, particularly where “arrangements” and “set asides” with respect to lenders must be considered. If the safe harbor can apply, how does one accomplish the 20-percent calculations where there is a different mix of partners, properties, and creditors at each tier in the structure?

The Joint Committee Description contemplates that regulations “may permit or require the aggregation of tiered or related partnerships for purposes of any or all determinations required under section 470.” Obviously, one can reach very different results depending on whether aggregation applies. Until regulations are promulgated, are taxpayers left to apply section 470 on both an aggregate and tier-by-tier basis, taking the worst of the two results? Similarly, if aggregation applies, how would it apply where there are different properties at each tier? If one were allowed to aggregate all properties and partnerships, it is possible to see how a SILO-replicating arrangement could “slip through the cracks.” That is,

suppose that a SILO-replicating arrangement is created between a taxable and tax-exempt partner in a lower-tier partnership, but the parties bring into that partnership for a small interest an upper-tier partnership that, itself, holds significant property and has significant taxable partners or debt. By bringing in the upper-tier partnership, the base against which the 20-percent safe harbor is applied would grow to a level that could permit complete defeasance of the taxable investor's investment at the lower-tier partnership.

Assuming that more limited aggregation must apply to prevent such arrangements, how would it apply? In order to prevent parties from "growing the base" against which the 20-percent safe harbor applies, would the parties have to apply the 20-percent safe harbor on a property-by-property basis? Seemingly, such an analysis would require that the parties determine the ultimate proportionate ownership of each property by each partner and then take a proportionate amount of each partner's section 704(b) capital account and recourse debt, allocating such debt and capital to such portion of the property. This amount then would be combined for every taxable partner with respect to every property. Obviously, with different partners at each tier, economic sharing ratios that vary for partners at each tier, and different loans in place at each tier, this analysis would be inordinately complex, even assuming that perfect information were available.

Similarly complicated questions arise in trying to apply the "20 percent of partnership debt" prong of the "allowable partnership amount" test, given that debt with respect to partnership property may be incurred at different levels in the structure. Presumably this analysis would require an analysis of the test again on a property-by-property basis and would require liability tracing rules akin to those used for purposes of section 163 or 265.

- Similar complications arise with respect to options in tiered partnership arrangements. The options rules contained in the amendment essentially operate with respect to arrangements whereby the tax-exempt can purchase, or can be forced to purchase, partnership property or interests for an amount other than fair market value. Questions arise in determining how the rules apply where options exist between tiers of partnerships or between a partner and a middle-tier partnership. Apart from the issue as to how the lowest tier partnership would know that such options even exist, an issue arises as to how such options fit into the scheme of section 470. Such options are not actually putting a direct interest in the property or partnership interest in the hands of a tax-exempt partner. However, such options may be increasing one or more tax-exempt partners' indirect interests in partnership property. On the other hand, depending on the mix of partners in the various tiers, the options may operate so as to decrease indirect tax-exempt ownership in the property. Or, the calculus may change from year to year based upon transfers of partnership interests among taxable and tax-exempt partners in upper-tier partnerships. Again, even with perfect information, making this determination would be extremely time consuming and difficult. It

may be that the Government would decide that any option at other than fair market value anywhere within the tiers would give rise to loss deferral under section 470. Such a result, however, would unfairly subject many legitimate arrangements to a loss deferral regime that Congress intended to apply only to SILO-replicating partnership structures.

5. Need for Other Exceptions/Rules

As was indicated above, we believe that, under the Technical Corrections Act, many legitimate pass-thru entities would not be able to consistently satisfy both parts of the Two-Part Test and would be subject to section 470, even though they are not engaged in the kinds of activities with which Congress was concerned in enacting that section. Therefore, we continue to believe, as stated in our prior submission, that section 470 should not apply to the pass-thru entity's property if no tax-exempt partner has significant operational control over the property or uses the property to a significant extent.²⁴ In addition, as explained in our prior report, we believe that partnerships satisfying the allocation rules in section 514(c)(9)(E) (*i.e.*, the "fractions rule") should be excluded from section 470. The "qualified allocation" rules in section 168(h)(6) are so restrictive as to be virtually useless in sophisticated partnerships like those that typically have tax-exempt partners, and there would be no potential for undertaking a SILO-like arrangement where the partnership's allocations comply with section 514(c)(9)(E).²⁵

Alternatively, we believe that a more general anti-abuse rule for the application of section 470 to partnerships, which incorporates an analysis of taxpayer intent and the facts and circumstances taken as a whole, warrants consideration, in lieu of an approach that, in effect, broadly sweeps legitimate partnerships "into" section 470 and then relies on specific exceptions to attempt to remove legitimate arrangements. We generally have not favored such a subjective analysis, given the problems inherent in planning in the face of uncertain standards. Nonetheless, if the law (or legislative history) contains appropriate specificity regarding the characteristics of the SILO transactions with which Congress is concerned, we think that such an approach could distinguish abusive transactions from those that are legitimate business transactions in a manner that is more accurate than the standards contained in the Two-Part Exception.

Nonetheless, if the drafters remain committed to an approach that relies primarily on identifying economic aspects of a partnership arrangement that bear some relationship

²⁴ As was explained in depth in our previous submission, the tax-exempt partner's continued control over, or use of, the property is a critical ingredient in a SILO transaction. Also, note that this approach has the added benefit in the tiered partnership context of being capable of analysis by the partnership that holds the property that could be subject to section 470. By permitting analysis with respect to the property itself, the partnership that is required to report under section 470 could more easily determine whether section 470 applies to property that it holds.

²⁵ We recognize that the fractions rule has been criticized in the past and that there may be some hesitancy to reference a rule that ultimately may be modified. Nonetheless, if the fractions rule is modified in the future, consideration could be given at that time to whether and how such modification would (or would not) apply in the context of section 470.

to a SILO, we believe it imperative that an additional, mutually exclusive, economic factor be adopted that would allow many legitimate partnerships to escape loss deferral under section 470. As one option, a factor could be adopted that would except from section 470 partnerships where all taxable partners satisfy a threshold projected variance in their investment return with respect to the partnership. Given that one of the hallmarks of a SILO transaction is that the taxable purchaser of the property undertakes no meaningful risk and has no meaningful upside with respect to the property, it seems that the Government could safely assume that a partner whose return is projected to vary by some reasonable amount is not engaging in a SILO-like transaction. Taxable partners with pure preferred interests (*i.e.*, interests that accrue only a fixed return and that are allocated losses only after partners of all other classes have depleted their capital) would have to be excluded from the analysis, but, being in a last-loss position, such partners would not represent candidates for replicating a SILO transaction.

We do not believe that this factor is an ideal means of excluding legitimate partnerships from the reach of section 470, as there are difficult issues of proof in showing variability in projected returns, and issues relating to the exclusion of partners with pure preferred interests in tiered partnership arrangements would be difficult. Nonetheless, this exception would be generally consistent with the approach taken in the Two-Part Exception and would offer an additional way out of section 470 for the many legitimate partnerships that would be unable to satisfy the Two-Part Exception.

6. Concerns Regarding Regulatory Authority

Even if a partnership's property falls outside the scope of section 470 by virtue of the exceptions currently included in the Technical Corrections Act, the bill would provide the Government with broad authority to issue regulations treating partnership property as tax-exempt use property "if such property is used in an arrangement which is inconsistent with the purposes" of section 470, determined by reference to certain factors. These factors include that:

- (1) a tax-exempt partner maintains physical possession or control, or holds the benefits and burdens of ownership, with respect to such property;
- (2) there is "insignificant" equity investment in such property by any taxable partner (with the term "insignificant" not being defined);
- (3) the transfer of property to the partnership does not result in a change in use of such property;
- (4) the deductions for depreciation with respect to such property are allocated disproportionately to one or more taxable partners relative to such partner's "risk of loss" with respect to such property or to such partner's allocation of other partnership items; and
- (5) such "other factors as the Secretary may determine."

We are very concerned with this extremely broad grant of regulatory authority and the vagueness of certain of the factors described above, particularly given the possibility that the IRS might attempt to issue regulations with retroactive application. Although we agree that the IRS should have the authority to issue regulations to subject those pass-thru entities that truly are being utilized to replicate SILO arrangements to section 470, we are concerned that the IRS might utilize this regulatory authority to challenge allocations and other arrangements that have nothing to do with the SILO-concerns Congress was trying to address in enacting section 470. This is particularly likely given the vagueness of certain of the factors and the lack of clear definition, in the statute and the JCT Description, of the particular kind of transaction with which Congress was concerned in enacting section 470.

Thus, we strongly recommend that this broad grant of regulatory authority be narrowed to delete factors 2, 4, and 5, above; that factor 1 be modified so as to allow *de minimis* use by a tax-exempt partner; and that the parameters of a SILO-transaction and the purposes of section 470 be defined more objectively (in the legislative history if not in the statute).²⁶ Such modifications would provide more certainty for both the Government and taxpayers as to whether various arrangements are subject to section 470, while ensuring that any regulations that ultimately may be issued are appropriately focused upon the abuses with which Congress was concerned in enacting section 470.

We also are very concerned that the Technical Corrections Act seemingly would not provide the IRS with authority to *exclude* from the scope of section 470 those partnerships that fail to qualify for one of the objective exceptions, but that are not being used to replicate SILO transactions. Although we believe that the drafters of the Technical Corrections Act can significantly reduce the number of legitimate arrangements that would be inappropriately subject to section 470 by adopting appropriate standards, there still likely will be some legitimate arrangements that fail to fall within an exception as a result of a "foot-fault." Such regulatory authority is even more critical if the additional exceptions we suggested are not added, given that more legitimate arrangements will be exposed to the application of section 470.

²⁶ Among other things, we note that, relying on factors 2 and 4, the IRS and Treasury seemingly could, in effect, eliminate the exception under section 465(b)(6) of the "at risk" rules for qualified nonrecourse financing without obtaining legislative approval. We respectfully question whether Congress intended such a result in enacting legislation aimed at eliminating SILO transactions.

7. Other Technical Issues

The definition of “tax-exempt partner” in the Technical Corrections Act still encompasses tax-exempt controlled entities. For the reasons set forth in our previous submission, we believe that taxable corporations and foreign persons that are taxed adequately in foreign jurisdictions should not be treated as tax-exempt entities for purposes of section 470.

Section 470 generally applies on a property-by-property basis. The JCT Description provides that regulations “may permit or require the aggregation of partnership property.” As was indicated in our previous submission, we believe the property-by-property application presents a host of problems. Thus, we support the ability to aggregate property in appropriate cases.

For the reasons set forth in our previous submission, RICs, REITs, and S corporations are not suitable vehicles for SILOs. Therefore, we suggest that it be clarified that none of these entities is treated as a pass-thru entity for purposes of applying section 470.²⁷

8. Concerns Regarding Effective Date

Section 6 of the Technical Corrections Act appears to apply to property acquired after March 12, 2004. As was indicated above, the IRS and Treasury have indicated that the IRS will not apply section 470 to disallow losses associated with property that is treated as tax-exempt use property solely as a result of the application of section 168(h)(6) in tax years beginning before 2006. The JCT Description indicates that the technical correction is not intended to supersede the rules set forth in the two regulatory moratoria that previously have been issued. Nonetheless, this concept is not reflected in the bill language. In addition:

- Given that the Technical Corrections Act was introduced in October of 2006, pass-thru entities would not have been able to even attempt to comply with the Two-Part Test for their 2006 tax years.
- Taxpayers may not be able to restructure arrangements that were put in place after March 12, 2004, in order to comply with the Two-Part Test in future years.
- As was indicated above, we believe it is inappropriate for the Technical Corrections Act to expand the portion of property with respect to which losses are disallowed retroactively.

²⁷ See C. Kulish, J. Sowell, and P. Browne, *Section 470 and Pass-thru Entities: A Problem in Need of a Solution*, 7 Bus. Entities 12, 25-26 (2005) (discussing why a REIT should not be treated as pass-thru entity for purposes of section 470).

To this end, we recommend that section 470 not be applied by reason of section 168(h)(6) to any property of a pass-thru entity acquired before the date the Technical Corrections Act was introduced. The amendments to section 470 similarly should apply only to property acquired on or after the date the Technical Corrections Act was introduced.²⁸ Nonetheless, even this effective date will produce an inequitable result where property is acquired after such date by partnerships that have an existing "arrangement" or "set aside" or an option at other than fair market value that cannot be modified or eliminated. Thus, we respectfully submit that "arrangements" or "set asides" or options at other than fair market value that are in place as of the effective date should be grandfathered, such that they do not cause a partnership to fail the Two-Part Exception.

We do not believe that such modifications present an opportunity for abuse (or should cause the legislation to lose revenue) insofar as we are not aware of any partnerships that have been structured to replicate the economics of a SILO arrangement. Indeed, the enactment of section 470 in the 2004 Act should have deterred the promotion of any such partnership arrangements.

V. Extension of Moratorium

As explained above, Congress intended for section 470 to apply only to those pass-thru entities that are engaged in, or being used to replicate, SILO transactions. As noted, we are not aware of any pass-thru entities that, in fact, have been structured or utilized so as to replicate SILO transactions. Nonetheless, a large number of pass-thru entities in a variety of different industries are potentially subject to the loss deferral rules merely because of the characteristics of their partners and their allocations. While section 6 of the Technical Corrections Act is a step in the right direction, it does not go far enough in exempting from the application of section 470 those entities that are not engaged in the abuses Congress intended to prevent. Further, given the vagaries of the legislative process, it is unclear whether technical corrections legislation will be enacted this year.

Therefore, if appropriate legislation is not enacted this year that removes legitimate arrangements from the application of section 470, we strongly encourage the Government to extend the moratorium on the application of section 470 to pass-thru entities that are not engaged in covered leasing transactions to tax years beginning before 2007. Failing to extend the moratorium in this situation not only would subject a large number of legitimate taxpayers to a loss deferral regime in contravention of

²⁸ We recognize that the effective date of a technical correction traditionally is the same as the effective date of the legislation to which the technical correction relates. We note, however, that section 7 of the Technical Corrections Act, relating to dividends received by a corporation that is a DISC or former DISC, breaks from this tradition and applies only to dividends received on or after September 26, 2006 (the date that the Technical Corrections Act was introduced), in taxable years ending after such date. We respectfully submit that the tax policy concerns justifying such a delayed effective date are extremely compelling in the context of section 470, such that the effective date of section 470 and the amendment thereto similarly should be adjusted.

Congressional intent, but also would create a compliance nightmare for both the Government and taxpayers given the lack of operating rules for the application of section 470 to partnerships. Further, extending the moratorium in late 2006 would not open the door for synthetic SILOs to be implemented in 2006 given both that most of 2006 already has transpired and that legislation is pending that would subject any synthetic SILOs structured in late 2006 to the loss deferral rules.

II. Comments on Proposed Technical Corrections to Code Section 355

A. Current Law

The Tax Increase Prevention and Reconciliation Act of 2005 amended the active trade or business requirement of section 355(b) by adding paragraph (3). Under section 355(b)(3), all members of a corporation's "separate affiliated group" (determined under section 1504(a) and without regard to section 1504(b)) ("SAG") are treated as one corporation for purposes of the active trade or business requirement. Section 355(b)(3) applies to distributions made after May 17, 2006, and on or before December 31, 2010.

B. Proposed Technical Correction

In the Tax Technical Corrections Act of 2006 (the "Act"), Congress has proposed to clarify that the term "separate affiliated group" in section 355(b)(3) would not include any corporation that became an otherwise qualifying member of the SAG (or of any SAG to which the active business rule of the provision applies for the same distribution) within the five-year period ending on the date of the distribution by reason of one or more transactions in which gain or loss was recognized in whole or in part. Additionally, the Act would provide that a business conducted by the corporation at the time it became a qualifying member will not be included. The Act also would clarify that Treasury shall prescribe regulations that provide for proper application of section 355(b)(2)(B), (C), and (D) to distributions to which section 355(b)(3) applies.

The Joint Committee on Taxation's description of the Act illustrates the proposed amendment as follows: Distributing spins off Controlled. Within the five-year period ending on the date of the spin-off, Distributing acquires, in a transaction in which gain or loss was recognized, stock ownership of Corporation such that Corporation would otherwise qualify as a member of Distributing's SAG. Corporation will not be considered a member of the SAG of Distributing if it is retained by Distributing in the spin-off. Moreover, if Distributing transfers the stock of Corporation to Controlled prior to the distribution, Corporation will not be considered a member of the SAG of Controlled. Likewise, a business conducted by Corporation will not be includable in either relevant SAG, regardless of whether such business is held by another corporation that otherwise is included in either relevant SAG.

C. Analysis of Proposed Technical Correction

Historically, the requirements for section 355 treatment were based on the definition of ownership as provided in section 368(c) (at least 80 percent of the voting stock and at least 80 percent of all other classes of stock). For example, section 355(b)(2)(D) provides that if control of a corporation, as defined in section 368(c), is acquired in a transaction in which gain or loss is recognized, the business of that corporation may not be relied upon to satisfy the active trade or business requirement of section 355(b). New section 355(b)(3), however, is based on the definition of ownership contained in section 1504(a) without regard to section 1504(b) (at least 80 percent of the

voting power and value of all stock). Section 355(b)(3) as enacted by TIPRA did not address the interaction of the affiliated group test of section 355(b)(3) and the control test of section 368(b)(2)(D), creating certain anomalies.

In one such anomalous example, which may have been the impetus for the proposed technical correction, it seems possible to satisfy the section 355(b)(3) active trade or business requirement in contravention of the policy (but not the language) of section 355(b)(2)(D) by acquiring stock of a corporation that satisfies the section 1504 ownership requirement, but not the section 368(c) ownership requirement. For example, if Distributing has an active business but Controlled does not, Controlled could purchase the common stock of Corporation, that represents 80 percent of the voting power and value of Corporation, but not acquire any of Corporation's non-voting preferred stock. As a technical matter, Controlled would satisfy the active business requirement of section 355(b)(3) because Corporation would be a member of Controlled's SAG. The proposed technical correction would provide that Corporation could not be treated as part of Controlled's SAG because it was purchased within the last five years. It seems appropriate to ensure that the principle of section 355(b)(2)(D) should continue to apply to members of a corporation's SAG that were acquired in a transaction in which gain or loss was recognized.

The proposed technical correction seems to go further, though. Excluding Corporation from the SAG seems to indicate that the "expansion" doctrine would not apply to an acquisition of stock in a transaction in which gain or loss is recognized. Treasury Regulation § 1.355-3(b)(3)(ii) permits a corporation to acquire a business in a taxable acquisition during the five-year period, provided that the business is an expansion of a pre-existing active business (*i.e.*, a business that qualifies as an active business under section 355(b)(2)). An expansion requires that the acquired business is in the same line of business as the old-and-cold business. It is wholly consistent with the operation and policy of section 355(b)(3), providing that all members of a corporation's separate affiliated group are treated as one corporation, that a taxable acquisition of a business by any member of the separate affiliated group potentially could qualify as an expansion regardless of whether by stock or asset acquisition. In fact, even without the enactment of section 355(b)(3), the Internal Revenue Service had determined that it was possible to rely on the expansion doctrine for a business acquired in a taxable acquisition of stock.

D. Recommendation

The American Bar Association Section on Taxation strongly recommends that the proposed technical correction not be enacted without modification to make clear that any such change will not interfere with the law that has developed to allow an expansion of a historic business. This could be accomplished by making clear that the expansion doctrine will be applied on an affiliated group basis, without regard to the SAG membership and providing examples to illustrate the principle.

We note that there are other anomalies created by the disparate ownership definitions that could be addressed by modifications to section 355. For example, assume

Controlled (with no business of its own) historically has owned all of the voting common stock of Corporation representing 80 percent of the value of Corporation, but does not own the nonvoting preferred stock, Corporation is part of Controlled's SAG and thus satisfies section 355(b)(3). If Controlled then purchases Corporation's nonvoting preferred stock prior to the spin-off, section 355(b)(2)(D) technically would apply. Presumably, Controlled should still be treated as satisfying the affiliated group test of section 355(b)(3), but it is unclear how to reconcile the two provisions and whether satisfying section 355(b)(3) would be dependent on arguing that the purchase is an expansion of a pre-existing business in Controlled or the Corporation itself (which does not seem sensible). Clarification on this interaction would be welcome.